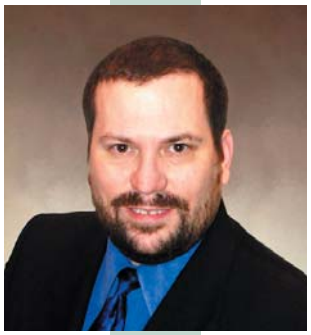

Tax Treatment Of Corporate Aircraft Use:

Entertainment, Amusement and Recreational Purposes (Part1)

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With particular attention to rules for Specified Individuals, attorney Troy Rolf begins this two-part series dealing with the tax implications of personal and recreational use of company aircraft.

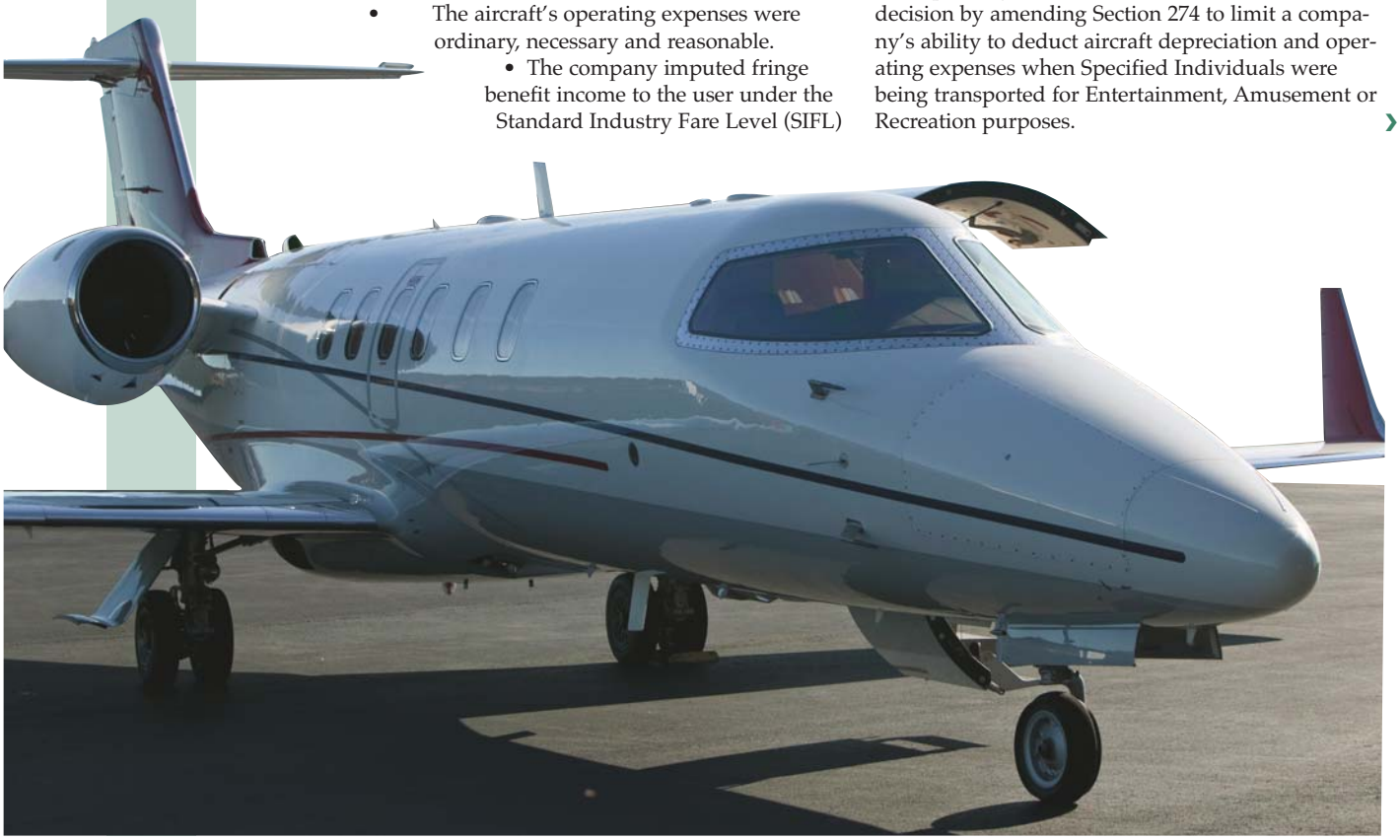
Prior to October 22, 2004, if a company permitted its owners and employees to use the company's aircraft for entertainment, amusement or recreational purposes when the aircraft was not otherwise being flown for the company's business purposes, the company was entitled to fully depreciate the aircraft and to deduct all aircraft operating expenses provided two baseline conditions were met:

- The aircraft's operating expenses were ordinary, necessary and reasonable.
- The company imputed fringe benefit income to the user under the Standard Industry Fare Level (SIFL) method or the fair charter value method.

Such deductibility was based in part upon an interpretation of Section 274 of the Internal Revenue Code by the U.S. Eighth Circuit Court of Appeals in a case that became known as the Sutherland Lumber decision.

THE JOBS ACT

The American Jobs Creation Act of 2004 (the "Jobs Act") partially overturned the Sutherland Lumber decision by amending Section 274 to limit a company's ability to deduct aircraft depreciation and operating expenses when Specified Individuals were being transported for Entertainment, Amusement or Recreation purposes. ›



Aircraft Index see Page 4

What the Boardroom needs to know about Business Aviation

The term "Specified Individuals" means any person who is the direct or indirect owner of more than 10% of any class of equity security of the taxpayer, and any officer or director of the taxpayer. The terms "Entertainment", "Amusement" and "Recreation" mean any activity of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips.

The Jobs Act limited the company's right to deduct the expenses and depreciation attributable to such flights to an amount equal to the amount that was received from the Specified Individual as reimbursement for the expenses of the flight or imputed to the Specified Individual as income for the flight. The Act, however, did not provide any details concerning how to calculate the proportion of a company's aircraft expenses and depreciation that is attributable to such flights.

INTERIM GUIDANCE FOR CALCULATION

The IRS subsequently provided interim guidance on the subject in Notice 2005-45, which states that companies must allocate all aircraft operating expenses and depreciation on a pro-rata basis, based on either total passenger-miles flown during a tax year or passenger-hours flown during the tax year. To comply with is requirement, the company must keep track of all the miles or hours flown by individual passengers over the course of an entire tax year, as well as each passenger's purpose (entertainment vs. non-entertainment) for being on-board the aircraft.

For example, if a company that elects to utilize miles as the basis for its calculation operates a flight of 800 miles with seven Specified Individuals on board, the flight would result in a total of 800 x 7 = 5,600 passenger-miles flown. If two of the Specified Individuals were traveling for entertainment purposes and five of the Specified Individuals were traveling for non-entertainment purposes, the 5,600 passenger-miles would be allocated as 1,600 entertainment miles and 4,000 non-entertainment miles.

At the end of the tax year, the company would divide the sum of all operating expenses and depreciation for the year by the sum of all passenger-miles flown to arrive at a cost per passenger-mile flown. The company would then go back and, on a flight-by-flight, passenger-by-passenger basis, multiply the cost per passenger-mile by the number of entertainment miles flown on a given flight, and subtract from that product the amount of reimbursement received from the Specified Individual, or the amount of income imputed to the Specified Individuals for the flight, in order to arrive at the amount that will be disallowed for such flight.

For a company that elects to utilize hours rather than miles as the basis for its calculation, the methodology is the same, except that hours flown is substituted for miles flown.

The methodology dictated by Notice 2005-45 was harshly criticized by taxpayers almost immediately after it was published for a variety of reasons,

including the burdensomeness of the record keeping required to implement the methodology, and the fact that allocating costs and depreciation on a passenger-by-passenger basis can lead to inequitable results.

Next month, we will address what has been done to simplify this rule as a consequence of revisions to the Jobs Act published on August 1 of this year.

Note: *This article should not be construed as legal advice or legal opinion on any specific facts or circumstances. The reader is urged to consult legal counsel or other advisors concerning his/her own situation and specific legal questions. Please be advised that, to ensure compliance with requirements imposed by the IRS, any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.*

Do you have any questions or opinions on the above topic? Get them answered/published in World Aircraft Sales Magazine. Email feedback to: Jack@avbuyer.com

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Aircraft Index see Page 4